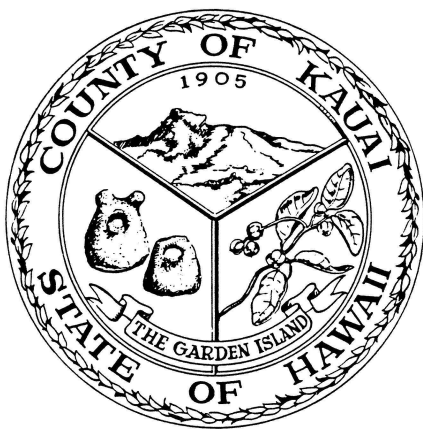


KAUA‘I ECONOMIC OUTLOOK

prepared for the County of Kaua‘i by the

**University of Hawai‘i
Economic Research Organization**

June 14, 2004



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prepared for

THE COUNTY OF KAUAI

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by the

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Executive Summary

Kaua'i's economy has been among the healthiest in the state in recent years. Mainland tourism has been strong and the construction industry has been buoyant. The local economy has powered ahead despite the range of external blows that impacted the state over the past several years, including the 9/11 terrorist attacks, the invasion of Iraq, and the outbreak of SARS (Severe Acute Respiratory Syndrome).

The strength of the Kaua'i economy has been fairly broad-based. Construction jobs rose almost 14% in early 2004, professional and business services grew over 5%, and education and health services were up almost 3%. The visitor industry has continued to be strong, with Kaua'i visitor arrivals on mainland flights running 2.7% above prior year levels during the first four months of 2004.

Overall job growth has continued and accelerated through 2003 and the early months of 2004, at a pace of about 4.0% on a year-over-year basis. Another sign of labor market strength has been the drop in the County unemployment rate over the years, to just over 4.0% in recent months, compared to 5.0% for the year 2003. Aggregate real income, the most comprehensive measure of the Kaua'i economy, rose 5.3% in 2002. UHERO's estimate for 2003 real income, based on county job, income tax, and statewide income figures, is for 4% growth. Real income on Kaua'i has risen every year since 1997, and even maintained limited growth of 1% during 2001.

Looking to the next several years, the rather attenuated recovery of Japanese travel to the island is expected to continue, with only a 6% rise over last year for 2004 as a whole. Further growth in the 14% range is expected in 2005 and 2006. This will still leave Japanese visitor numbers far below their 2001 level of 122,000. The number of mainland visitors is expected to rise 3% in 2004, a substantial improvement over last year's modest growth of 1.6%, and the domestic length of stay will remain high at about 7.2 days.

Total visitor arrivals this year should expand by just over 4%, largely on the strength of mainland visitors. This would be the first annual increase in arrivals since 1999. Because of expected declines in the international length of stay, growth in average daily census will fall short of the very high rate posted last year.

With a healthy tourism industry, we expect another 400 jobs to be added to the accommodation and food services sector over the next three years. Transportation, trade and allied areas will also add workers at a moderate pace. Changes in the cruise ship industry now promise a larger role for cruise visitors in the island economy, but cruise visitors will remain a limited part of the visitor industry for the foreseeable future.

Kaua'i's construction sector is no exception to the statewide boom in housing caused by very favorable lending rates, local income growth, and offshore demand. While permitting activity has backed off quite a bit from the \$210 million worth seen in 2001, we will still see high levels of construction employment for at least the next several years. The service sector will continue to be a focus of job and income growth. Overall, service jobs are expected to expand by 2.7% this year before slowing to 2.2% in 2005.

In sum, we expect solid growth for the Kaua'i economy through 2006. Aggregate growth will drop down a notch from the particularly rapid expansion experienced last year. Overall job growth will be just under 2% this year, compared with 3.8% in 2003, on par with the job forecast for Hawai'i as a whole. Job growth of 1.5% is seen in 2005 and 1.2% in 2006.

Real (inflation adjusted) personal income represents the best measure of overall economic performance. Here we expect only a little slowing from the very robust performance of recent years. Real income for Kaua'i will grow 2.8%–3.2% over the next three years. Taking into account somewhat faster inflation, nominal (current dollar) income will expand by 5.5–6% for the next three years.

Looking further ahead, we can identify a number of important factors that will shape the Kaua'i economy over the next decade. One is a continuation of the gradual diversification we have seen away from sole dependence on first agriculture and then tourism toward the non-tourism service sector, including areas such as business, education, health and social services, and high tech.

This is not a rapid transition, and tourism will continue to play the leading role in Kaua'i's economy well into the future. Nevertheless, these changes do require attention to the prerequisites for healthy service sector growth. Of particular importance will be improving the island's educational system. Recent collaborative efforts by the County, the Department of Education, the local high tech community and others are useful first steps in this direction.

Because the island's economic heart will continue to be tourism, it will also continue to be vital to provide the infrastructure necessary for higher-revenue tourism growth. Improvements to roads, parks, utilities and ports will be necessary, and these may present funding challenges and prompt lifestyle choices for the island's residents.

Debate over such lifestyle issues has reopened with the more rapid growth of recent years. Of particular concern has been the impact of rapidly rising home prices on housing affordability. While low interest rates and moderate gains in income have helped, households with low-to-medium income face increased problems finding affordable housing. Only marginal additions to public and private housing in an affordable price range are likely in the next half decade.

The natural limits to growth have also been raised. Appropriate use of land, access routes and congestion represent areas of ongoing discussion. The designation in March 2003 of 53,000 acres on Kaua'i and Ni'ihau as Critical Habitat drives home the importance of these questions, and the surge of activity anticipated near Po'ipū will raise particular challenges on the South Shore. In-migration itself has raised concern among kama'āina that Kauai's uniquely casual and congenial local environment may be threatened. At the same time, an inflow of well-educated professional workers may help to facilitate the growth of a diversified technically-sophisticated economy on Kaua'i.

These are the broader opportunities and challenges that Kaua'i residents will face in coming years as they map out a growth strategy that provides a high standard of living and a high quality of life for themselves.

I. KAUA'I ECONOMIC CONDITIONS

Overview

Kaua'i's economy has sustained healthy economic performance into 2004. In several respects, it continues to show a better track record than the other three Hawai'i counties. Kaua'i's economy has powered ahead despite the range of external blows that impacted the state over the past several years, including the 9/11 terrorist attacks, and the invasion of Iraq and the outbreak of SARS (Severe Acute Respiratory Syndrome).

The County economy was not completely spared the effects of global developments. Economic activity on Kaua'i did slow somewhat during 2001, in part due to 9/11 but also to the combined impact of a national collapse in the high technology sector and the local effects of closing the Lihue Plantation sugar operation. Still, overall job growth on the island still managed to expand by nearly 1.0% in both 2001 and 2002. By the middle of 2002, a more robust job recovery was well underway.

Job growth has continued and accelerated through 2003 and the early months of 2004, at a pace of about 4.0% on a year over year basis. This rate of job creation compares very favorably to both O'ahu and the other Neighbor Islands. State non-farm job growth was running about 2.0% in the first four months of 2004. Maui's job growth for the same period was just over the state average, and the Big Island was registering about 3.0%.

The strengthening of the Kaua'i economy in recent experience has been fairly broad-based, as reflected in sectoral job statistics. Construction jobs rose almost 14% on Kaua'i in early 2004, about the same pace as the previous year's annual average, stimulated to a great extent by a continued low interest rate environment and also to offshore demand. Professional and business services grew over 5%, and education and health services were up almost 3%. The relative strength of these sectors was not atypical for Kaua'i, but reflects in part the grad-

ual trend toward diversification of Kaua'i's tourism-dependent economy.

The UHERO-Kaua'i Interactive Database. Data on the Kaua'i economy can now be accessed online using the UHERO-Kaua'i Interactive Database. The interactive database, developed under a grant from the County of Kaua'i Office of Economic Development, allows users to view graphical and tabular presentations of economic time series and to download data for use on their local computer. In coming months, the system will be expanded to include a broad range of economic and demographic data on the Kaua'i economy, and to permit inter-county comparisons. Browse to (kauai.uhero.isdi-hi.com).

Now that the post-9/11 weakness is behind us, Kaua'i's tourism sector has also begun to move forward. The hospitality and leisure category of jobs was growing at nearly a 4.0% rate in the early months of 2004, and retail jobs rose by almost double that growth rate in the same period.

Strong job creation is a statewide phenomenon, and stands in stark contrast to the anemic national labor market conditions that have prevailed since the start of the 2001 national recession. The national job market has only recently begun to show significant signs of improvement.

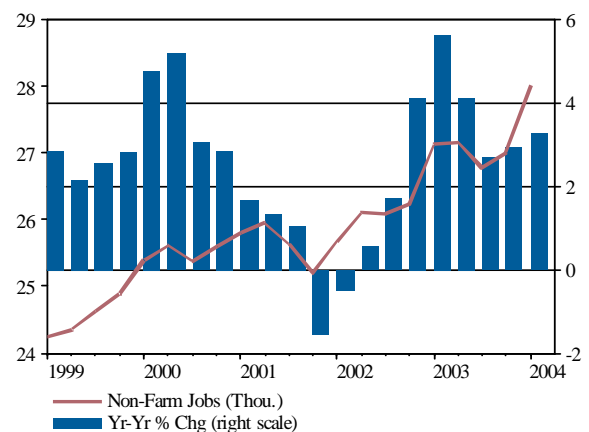


Figure 1: Kaua'i Non-Farm Jobs

Another sign of strength in the Kaua'i labor market is the drop in the County unemployment rate

over the years. In 1997, the County unemployment rate stood at 11.3%. It has dropped steadily in almost every year since then. In the early months of 2004, the Kaua'i civilian unemployment rate averaged just over 4.0%, compared to 5.0% for the year 2003. By comparison, the state unemployment rate averaged just under 4.0% for early 2004, but recall that Neighbor Island unemployment figures almost always run higher than on O'ahu because of the relative smaller size of the labor markets in the outlying county economies.

The most comprehensive measure of the Kaua'i economy is real personal income, which records the income accruing to Kaua'i residents from all sources. Personal income figures measure changes in standard of living for Kaua'i residents but also reflect the level of economic activity taking place. "Real" personal income numbers are adjusted for inflation to permit valid comparisons over time.

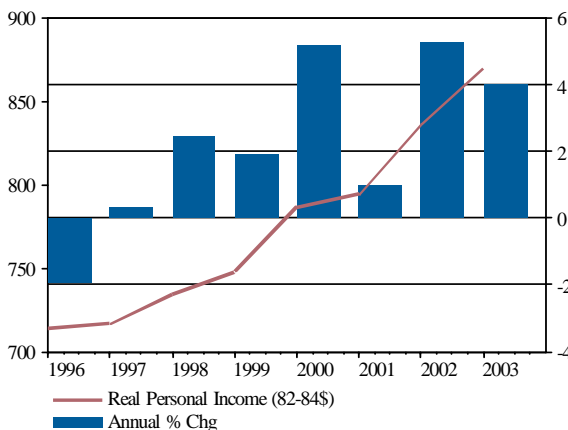


Figure 2: Kaua'i Real Personal Income. (UHERO estimate for 2003)

Aggregate real income for Kaua'i County rose 5.3% in 2002. UHERO's estimate for 2003 real income, based on county job, income tax, and statewide income figures, is for 4% growth. Real income on Kaua'i has risen every year since 1997, and even maintained limited growth of 1% during 2001.

In the remainder of this section, we review conditions in important sectors of the Kaua'i economy.

Tourism Tourism is the single largest industry on the Garden Isle, generating perhaps one-third of the County's real income in a typical year. The tourism sector is actually an amalgam of several interrelated industries, including hotels, transportation, eating and drinking establishments, and retail trade. It is always difficult to draw an exact line between tourism and non-tourism spending in some of these components, but few dispute the fact that the tourism share for Kaua'i's economy is high, perhaps higher than any other county in the state.

Fortunately, Kaua'i's tourism sector was not hit as hard as the rest of the state by the fallout from 9/11 or other negative external developments. In part, this was due to the island's greater dependence on Mainland visitors, especially condominium and time-share owners, who continued to travel even as Japanese tourism dried up. Kaua'i's time-share component proved to be a genuine blessing in the post-9/11 period, because owners continued to come in part because they had already paid for it.

Total visitors annually to Kaua'i broke the 1 million barrier in 1998, and even though there was some understandable decline in 2001 and 2002, they have hovered just below that level in the past few years. It is usually the case that summer traffic is enhanced by seasonal factors and added airlift. The summer season has been growing in importance for Kaua'i tourism, and it has been becoming more family-oriented in recent years.

Last year, Kaua'i had a very good spring and summer season, with increases in length of stay (about a day longer than normal) bringing the number of visitor days to levels not seen since 2000. Underlying reasons for this strength may have included added airlift, plus a lot of free publicity from celebrity weddings and the identification of Kaua'i by travel magazines as one of the world's best island get-aways. Higher hotel occupancies were only part of the picture. Vacation rental properties, of which Kaua'i has many, were also noticeably more full.

Po'ipū reported a strong increase in family business, attributable to its diversified mix of accommodations and activities. For example, the South

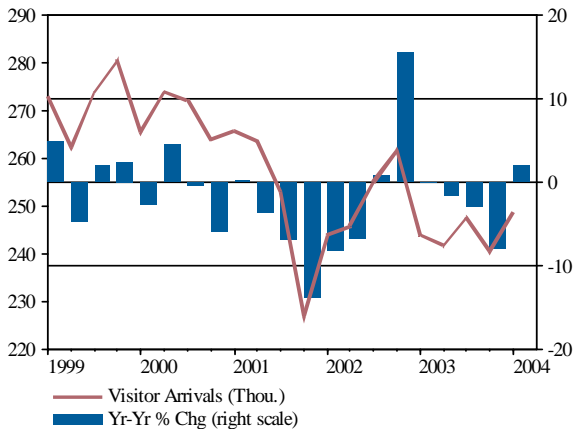


Figure 3: Kaua'i Visitor Arrivals

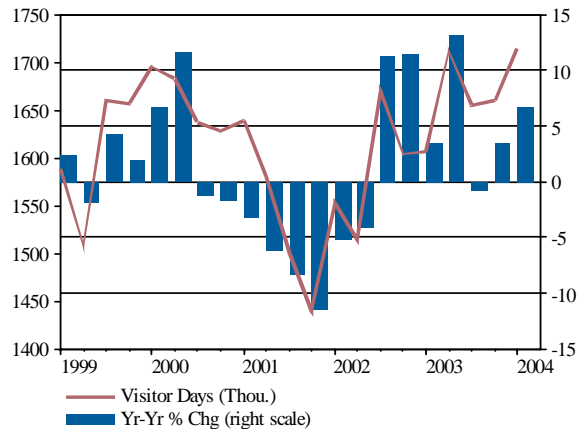


Figure 4: Kaua'i Visitor Days

Shore, rather than the North Shore, is now the base for Na Pali Coast boat cruise charters.

Some of the concerns of earlier years for Kaua'i's visitor industry do not seem as menacing now. For example, the introduction of efficient small jetliners has enabled more direct flights to Kaua'i without lengthening the runway, a controversial issue that both Kaua'i and Maui have faced.

Kaua'i's visitor plant has seen only limited change in recent years, but there are now changes in the pipeline, most on the South Shore. The Waiohai property, which was taken out by Hurricane Iniki back in 1992, is finally coming back as time share. Construction of the 220 time share units (and 7 hotel rooms!) will be completed this summer six months ahead of schedule. Developers of the Po'ipū Beach Hotel to be located next door will go before the Planning Commission in June for permit approval for the 120 unit first phase. Po'ipū Beach Villas is before the Planning Commission with a proposal for a 323 unit condo resort development. The large Kukui'Ula development project has plans for 64 hotel units and 120 time shares as part of their first phase, now before the County Council for zoning modifications.

Further West, Kikiaola Land Co. recently received county approval to expand its Waimea Plantation Resort to eventually include 150 cottages, and Robinson Family Partners has been obtaining

state and county permits to build 250 cottages to be named Kapalawai Resort on 170 acres of the family's original homestead at Makaweli.

On the North Shore, Starwood Corp. has been meeting with Princeville residents and County officials to discuss plans for a new 370-unit time-share resort on a section of the bluff overlooking Anini Beach. While the plan is still described as "conceptual" by Starwood, ground breaking is expected as early as next year.

Kaua'i's older hotel inventory will need to be renovated in coming years. These hotels may have to change hands for that to happen. With Kaua'i's shift away from the "budget traveler" market, the demand for upgraded facilities has increased; this may require substantial changes in some properties.

The importance of the time-share industry on Kaua'i is hard to overstate. Time-share units on Kaua'i comprised 34% of the state total in 2002, and represented at last one-fifth of the island's visitor accommodations. Time share properties have only recently begun to grow in importance on the other neighbor islands. Even though time-share visitors may not spend as much in the Kaua'i economy as other visitors, they can prove a blessing in uncertain times because time share visitors often come regardless of negative developments, having already paid in advance for a large cost of their visit.

Time share visitors provided just such a cushion for Kaua'i tourism in the wake of 9/11.

On another front, the cruise ship industry has and will continue to make inroads into Kaua'i tourism. The entry of Norwegian Cruise Lines' *Pride of Aloha* in July will mark the reintroduction of American flag cruising among the Hawaiian islands. NCL's new cruise schedule will have overnight port visits at Nawiliwili Harbor, increasing the local economic impact. The introduction of larger vessels will require improved infrastructure at Kaua'i's port facilities and will increase port congestion. (See the box, *Hawai'i Cruise Industry On the Rise*.)

Observers within the Kaua'i tourism industry continue to note that Kaua'i is becoming more of a "celebrity" destination, an image that Maui has long tried to cultivate consciously. Some of this changing image may relate to recent publicity, but it may mean that Kaua'i will be less of a "quiet hideaway" in the future. Along with this changing image will come higher visitor expectations.

Escalated costs of inter-island travel have affected the island's tourism sector as well. Kaua'i tends to be a favored haunt for kama'āina visitors. But fewer inter-island flights, higher airfares, and greater inconvenience may begin to erode this market. Some have remarked that it is almost easier and cheaper to travel to a mainland destination such as Las Vegas than it is to go inter-island these days.

Real Estate As has been the case elsewhere in the state and throughout the mainland, the continuation of extremely low mortgage rates has contributed to a very robust real estate market on Kaua'i. Home sales, mortgage financing and re-financing at banks, and the construction industry have all benefited from lower rates.

The strength of the Kaua'i real estate market is reflected in sales and price statistics. The residential sales volume continues strong, and median sales prices have been accelerating. The single family home median price in April 2004 was \$477,500, up

from \$326,495 a year earlier. This jump is likely due in part to the changing mix of units sold.

The climb in home prices has been occurring all across the island, but it has been noticeable particularly in the Princeville area on the North Shore, where prices may have been more of a bargain earlier. The market has been particularly strong for high-end properties. Yet all segments of the market have participated, including condominium and raw land sales.

Some of the recent increase in real estate activity has been linked to young professionals, encouraged by lower mortgage rates, leaving the nest for homes of their own. In addition, the mix of migrants to the island appears to be younger than in the past, including telecommuters in various high-tech professions. Although retirees are still a key part of this market, the age profile of mainlanders is increasingly younger. Many new Kaua'i residents are establishing island homes that they plan to maintain in retirement.

The offshore market is largely second home or summer home owners. In addition to demand from California residents, there has been increased demand from the Midwest and East Coast. Kaua'i upper end second homes may be in strong demand partly because Kaua'i—particularly the Princeville area—remains a relative bargain compared to Kona and Maui.

With home prices rising across the Garden Isle, there is some concern that a surge in housing costs will crowd out potential "homegrown" buyers, especially younger ones just starting out as well as working families with modest means. The inventory of truly affordable homes has dwindled in recent years. This July, forty more units in phase 2 of the County's Kalepa Village project will be completed, and there are plans to start quickly on stage 3. Kaua'i Housing Development Corporation may also participate in further additions. There are plans for sixty more affordable housing units in Koloa Town. Private developers may add to the affordable pool too, both at Halelani Village in Puhi and in the Hanamaulu triangle near Lihue.

Hawai'i Cruise Industry On the Rise

Hawai'i's small cruise industry is about to get bigger. This July Norwegian Cruise Lines (NCL) will introduce the *Pride of Aloha* for interisland cruising. Under the Jones Act exemption that permitted American reflagging of the *Pride of Aloha*, NCL plans to add the troubled *Pride of America*, which sank in its German shipyard earlier this year, and one more ship to the island cruise market by 2007.

With cruise industry growth in the pipeline it is useful to consider the impact of cruise ships on the state and Kaua'i economies.

To date, Hawai'i's cruise industry is small but not insignificant. For example, in the first quarter of this year, 50,349 out-of-state passengers either arrived in Hawai'i aboard cruise ships or embarked on the ships in the islands. That represents just 3.1% of total visitors to Hawai'i during the period. (Last year 61,399 arrivals were on cruise ships.) Cruise visitors spent an average of 4.4 days in Hawai'i aboard ship and those who boarded in the islands spent another 1.5 days on average in the islands prior to their cruise. On average cruise visitors spent \$105 dollars per day during shore visits. Existing cruise ships make just a single port call on the Garden Isle.

Clearly the planned expansion by NCL will add substantially to the number of cruise passengers in the islands. It will also add to the direct economic impact. NCL is expected to eventually employ 3,000 American residents for their Hawai'i cruise activities, most to be hired from within the state.^a Without the need to sail beyond U.S. waters, these ships will also spend more time within the state, leading to additional shore visits and spending. Finally, as U.S. flag vessels, onboard revenues will also be subject to state taxation.

For Kaua'i, there may be a significant increase in the local impact of cruise visits. Unlike the previous NCL arrivals, which called at Nawiliwili Harbor for just 9 hours, the *Pride of Aloha* (and presumably its siblings) will be arriving at 7:00 AM and overnight in harbor before departing at 1:00 PM the following day. Not only does this increase the likely amount of shopping and dining expenditures, but the extended stay makes longer shore excursions possible. According to a report in *The Garden Island* (January 4, 2004), the overall number of cruise ship days on Kaua'i will increase by over 35 percent this year, and once the second NCL ship come online—probably not until 2005—there will be a cruise ship in port five out of seven days of the week.

What are the economic implications of current and expected cruise travel to Kaua'i? To put the numbers in perspective, last year 222,022 cruise visitors made a one-day port call to Kaua'i. By comparison, total visitors to Kaua'i last year accounted for 6.6 million visitor days. In addition, the average daily expenditure of cruise visitors (about \$100 per day) is considerably lower than the \$160 spent by the average traveler. A rough estimate of the direct expenditure impact of cruise visitors to Kaua'i in 2003 might be about \$22 million, compared with total Kaua'i visitor spending of about \$1 billion.

The growing cruise industry is not without its detractors. The increased number of ship visits and longer port stays will increase port congestion, which has increased delays for some businesses. Roadway congestion and environmental concerns have also been raised.

The expected growth in cruise visitors in coming years will raise the importance of cruise lines to the island economy. Simply having cruise visitors in harbor for nearly an additional day could nearly double their spending on Kaua'i. Still, the cruise industry will continue to be a limited piece of the local tourism economy well into the future.

^aNCL estimates that its Hawai'i cruise ships will eventually contribute \$250 million annually in wages and salaries and \$500 million per year in overall economic impact. Presumably these estimates include all indirect effects and may be an overstatement of the actual impact.

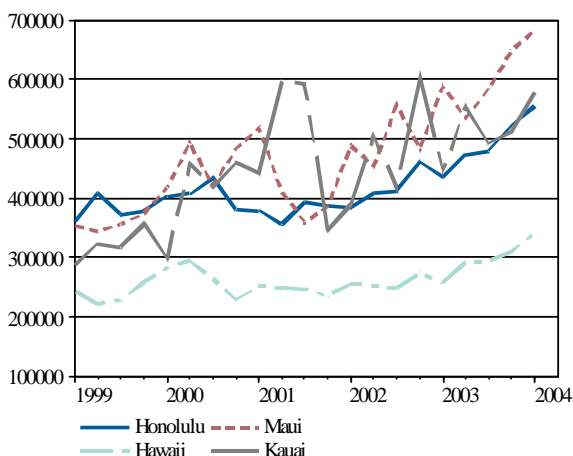


Figure 5: Average Single-Family Resale Prices

The availability of homes that would be considered “affordable” by households with moderate income has also dwindled as the market has heated up. It is likely that land for between 75 and 200 low and middle income homes will be provided in the Koloa Town area as part of the Kukui‘Ula development, and the planned Village at Po‘ipū development is intended to target mid-to-upper income families with homes priced in the \$500,000 range. (See below.) The limited supply of relatively inexpensive homes is a particularly difficult challenge. Builders are less inclined to build affordable housing, especially if they are also expected to provide infrastructure, because the profit margins on these kinds of homes tend to be smaller than on other projects. Public subsidy is one partial solution, but funds are scarce there also.

One controversial aspect seems to be the fact that some lower priced housing may be taken out of the local market to be converted to vacation rentals. Owners often can realize more rental income this way than renting long term to local residents. We are not aware of any hard statistics on the prevalence of such renting, and there is an ongoing debate about whether this is a significant problem. Some realtors argue that vacation rentals usually involve the more luxurious homes.

Development Like elsewhere in Hawaii, pent-up demand and low interest rates have combined to fuel

a construction boom on Kaua‘i. The value of building permits on the island has reached 150% of that of a decade ago. (These permit levels reflect only those for residential construction, since the County ceased to report data for commercial projects and additions and alterations in 2002.) The construction rebound started at the end of 2001, partly sparked by interests from out-of-state residents.

Plans for development on Kaua‘i generally proceed slowly because of significant rezoning, environmental impact, and permit processes that must be completed. Alexander & Baldwin (A&B) and its joint venture partner DMB Associates, have continued planning and design work the Kukui‘Ula project in Po‘ipū. This is a high end (\$1–\$3 million) home development that will include up to 1,500 units. The efforts so far have included engineering, marketing, economic, environmental impact, archaeological, and other technical studies. Another A&B project is the Port Allen Marina Center. Marketing, leasing, and tenant improvements continue on this 24,000 square foot Center overlooking the Port Allen harbor.

Also on the South Shore, the Kiahuna Mauka community, to include 120 units adjacent to the Kiahuna Golf Course, is in its second phase of subdivision application before the Planning Commission. Development rights are in escrow for a company planning a 98,000 square foot addition to the Po‘ipū shopping village. A 30,000 square foot shopping development is also planned in Koloa Town.

All of this development activity in South Kaua‘i will increase the need for infrastructure expansions to meet the demands of a larger transient and resident population, particularly road and park development.

Another aspect of development on Kaua‘i concerns the use of former sugar lands. The 1996 shutdown of McBryde Sugar and the exit of Lihue Plantation in 2000 left a significant amount of agricultural and commercial land available for lease. Agricultural land leasing has been moderately successful in the past few years.

Grove Farm Company usually plays a significant role in development on Kauaʻi. There are no longer any residential lots available in Grove Farm's Puakea Master Plan. A major renovation of Grove Farm's nearby Kukui Grove Mall has been underway over the past year, with the addition of a new Home Depot adjacent to the Mall.

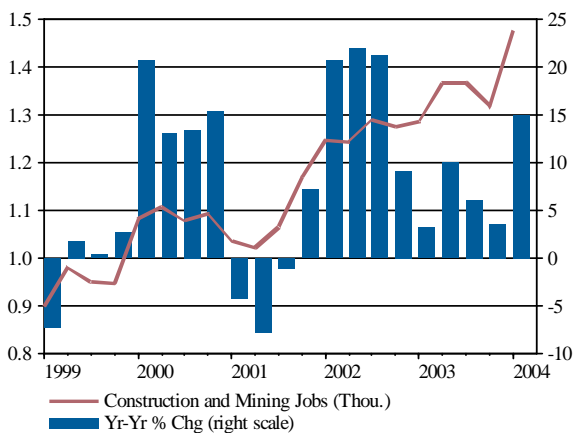


Figure 6: Kauaʻi Construction Jobs

High Technology The high tech industry continues to expand on Kauaʻi, led by the Pacific Missile Range Facility (PMRF), which provides a number of higher income jobs in West Kauaʻi. Unlike impacts on tourism, the terrorism events of recent years have actually caused an acceleration of activity associated with the Missile Range. The facility provides jobs and also augments Kauaʻi's visitor industry with transient travelers and business conferences.

The economic contribution of PMRF activities is substantial and growing. For example, each time the Missile Range has an exercise, there are on average about 300 associated visitors. The Range estimates that the direct injection into the local economy is over \$3 million per exercise. PMRF projects that there will be about 20 such exercises per year by 2009.

Prior to 1999, there was no significant high tech activity on Kauaʻi outside the Missile Range itself. This changed in April of that year when the first phase of the Kauaʻi Visitor and Technology Center in Waimea opened 8,500 square feet of space to

major technology tenants. That space is now fully occupied.

Ground was broken on Phase II of the Waimea Center in June 2002, and that Phase was dedicated by U.S. Senator Dan Inouye in April 2003. It is also now fully occupied. Funding sources were the Economic Development Administration of the U.S. Department of Commerce, the U.S. Department of Housing and Urban Development, and the State's High Technology Organization.

At the same time, a third phase of the Tech Center was opened in a 21,000 square foot vacant building in the Kukui Grove Shopping Center in Lihue. That space is now occupied by Solypsis Corporation, a high-tech company that performs research and development for the military.

Recently the Navy requested from the state an additional 270 acres of land adjoining PMRF, as well as another 5,371 acres to act as a buffer zone, which would be put into permanent agricultural and preservation use. In May 2004, a 25-year lease for the land was granted to the Navy, not without some local opposition.

Even aside from the Missile Range, there is evidence that Kauaʻi's small business telecommuter high-tech component is growing. This kind of increase must have come at least partly from an increased telecommuter component. There is some anecdotal evidence that telecommuting has allowed existing island residents to earn significantly more off-island income, for example as programmers, educators, or art dealers. The increased gravitation toward outsourcing all over the world has helped to foster this trend.

Banking and Finance The relatively low interest rate environment continued over the last year. Thus, residential lending has continued to be strong on Kauaʻi, as elsewhere in the state and nation. In recent years, banks have reported extremely high levels of refinancing activity due to low 30-year fixed mortgage rates, and even lower 15-year rates.

While refinancings have slowed through the state, new home sales are keeping the mortgage market busy.

Thus, the local Kaua'i financial sector remains healthy and quite busy. In the first four months of 2004, there was over a 6% increase in financial activity jobs on the island.

Agriculture Farming activity has become a smaller but still visible part of Kaua'i's economy. The closing of AMFAC's Lihue Plantation in 2000 led to a significant net loss of agricultural jobs. The exit of sugar in recent years has highlighted the need for diversified agriculture efforts.

However, Gay & Robinson (G&R) sugar operations remain productive as one of the only two remaining sugar plantations in the state, located on very high-yielding acreage along Kaua'i's southwest shore. There are two critical conditions for sugar cultivation—water and sunlight. Sugarcane companies that have exited the island economy were ones located on marginal land. G&R land is located on Kaua'i's sunny leeward side and uses drip-irrigated from water sources in the higher elevations.

Along with the Missile Range, G&R is a major support to the west side economy. It owns 438 homes there to house its workforce and pensioners, and the company plays an important role in maintaining infrastructure such as roads and sewers.

Last year, G&R harvested its biggest crop ever, over 57,000 tons of sugar. This was up from just under 55,000 tons in 2002. Until recently, G&R was in an expansion mode, planning to lease and cultivate 4,000 more acres of State land previously leased by AMFAC's Kekaha Sugar. This year, however, it announced that it would suspend planting on about a quarter of its acreage, primarily due to low sugar prices. These lower prices are partly the result of the current low carbohydrate diet craze, plus U.S. trade agreements that now allow somewhat greater access for cheaper foreign sugar producers than in the past.

The lower revenues caused by these falling sugar prices have caused unanticipated cash flow problems for G&R. Part of this stems from the need to purchase the Nawiliwili Harbor bulk sugar terminal from AMFAC. G&R now cultivates a total of about 11,000 acres in sugar. Planting will be suspended mostly on the newly leased former Kekaha land. Cane on that land will be harvested, then the acreage will be taken out of production.

The company could resume planting there if sugar prices rise or other sources of revenue are identified. G&R has indicated interest in diversifying in two areas: participation in trash-to-energy production for the County, and the production of ethanol as a fuel. The ethanol project depends on local demand for that fuel and the extent of federal subsidies.

Some diversified agriculture efforts on Kaua'i continue to struggle. For these crops, margins have been squeezed due to rising costs. One of Kaua'i's competitive problems in diversified agriculture is that other countries with similar products have lower costs and bigger programs to support exports. And overall, Kaua'i has transportation and other infrastructure impediments, such as power and water availability, relative to many other places.

Papaya exports have been down in recent years because the airport disinfestation facility was closed due to management problems. Efforts continue to reopen that facility. The CEATECH shrimp farm received a recent blow when its output was placed under quarantine due to outbreak of a white spot syndrome virus. This virus is contagious and fatal for the shrimp, but poses no threat to humans. If isolated, authorities report there is a very good chance of containing the disease.

Despite the unevenness of Kaua'i's transition from a sugar-based to a more diversified agriculture sector, some positive initiatives are worth noting. For example, it is hoped that range-fed beef will become a near-term use of former sugar land. Range-fed beef from Kaua'i may effectively compete for mainland market share as a healthier alternative to grain-fed beef, which is relatively higher in

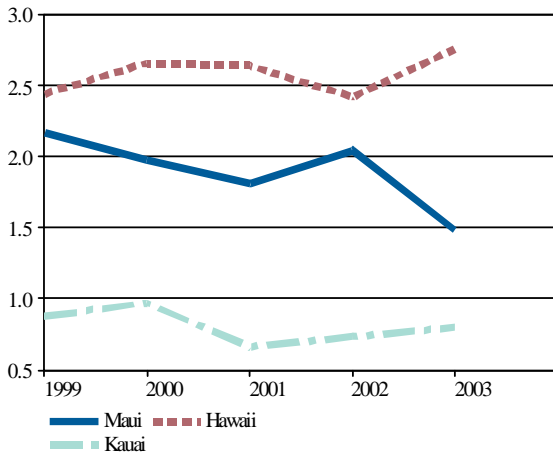


Figure 7: Agricultural Jobs by County (Thou.)

fat and antibiotics. Kaua'i has been participating in a statewide effort to move in this direction.

Small Business, Retailing and Wholesaling The fortunes of Kaua'i's wholesale and retail trade sectors are linked, in large part, to the performance of the tourism industry. As expected, the tourism slowdown in 2002 negatively impacted the trade sector. Wholesaling on Kaua'i is dominated by hotel and restaurant accounts. As tourism has improved, health has been returning to this sector. As growth in tourism accelerates, further progress can be expected.

A good gauge of small business health and attitudes is found in Chamber of Commerce observations. The Kaua'i Chamber now estimates that 87% of its membership is accounted for by small businesses with ten or fewer employees. And Chamber membership is rising. The Chamber states that most members continue to be optimistic about the future.

The Chamber leadership have noted two major concerns in the current environment. One is the rising cost of health insurance. Another, echoed in other sectors, is difficulty finding qualified employees, especially in certain technical skills such as engineers and mechanics. This involves the local education sector, a subject to which we will return below. Local secondary schools may not always pre-

pare graduates adequately for higher education or the increasingly sophisticated labor market.

Overall, observers now report that conditions are buoyant for small businesses on Kaua'i. Low interest rates have truly helped the bottom line for many small businesses. After all, short and long term borrowing rates have been lower in recent experience than ever before in the professional life of most small business operators. At the same time, there are some concerns that small business formation is constrained by a lack of the necessary capital. Often only personal assets are available to be pledged for a new venture.

Energy An ongoing issue on Kaua'i in the past has been the provision of electric power. Kaua'i is the only one of Hawaii's four counties that has traditionally relied on power generation facilities controlled by outside owners. The recent sale of Kaua'i Electric by its Mainland owners introduced considerable uncertainty about the future of electric power on the island.

A three year effort by local residents resulted in the establishment of the Kaua'i Island Utility Cooperative (KIUC), the state's first consumer-owned public utility in 2002. KIUC is a not-for-profit, tax-exempt cooperative organization owned only by the customers it serves.

High energy costs continue to be a challenge on Kaua'i, owing largely to the absence of the economies of scale that larger utilities can exploit. Total energy demand in Kaua'i's small economy is simply too small to provide a base over which a utility's high fixed costs can be spread. Sugar's diminution has exacerbated the problem. In the past, the burning of the bagasse by-product has augmented fossil fuels as an energy source. Now, virtually 100% of Kaua'i's electricity needs must be met by burning fossil fuels. Of course the current high oil prices make matters worse. KIUC has been working to hold the line on costs both by increasing the efficiency of generation equipment and conducting fea-

sibility studies on renewable energy sources, such as wind and biomass.

Long Term Economic Development and Diversification Challenges Like much of the state, Kaua'i's economy remains highly specialized in a limited number of industries, including tourism, agriculture and federal government activities. In addition, its small population places practical limits on infrastructure development, transportation, and local government finances.

Local planners recognize these constraints, and have objectives to diversify the economy through business development in the areas of science and technology, health and wellness, and agriculture. These are truly long-run objectives that may pay dividends only gradually over time.

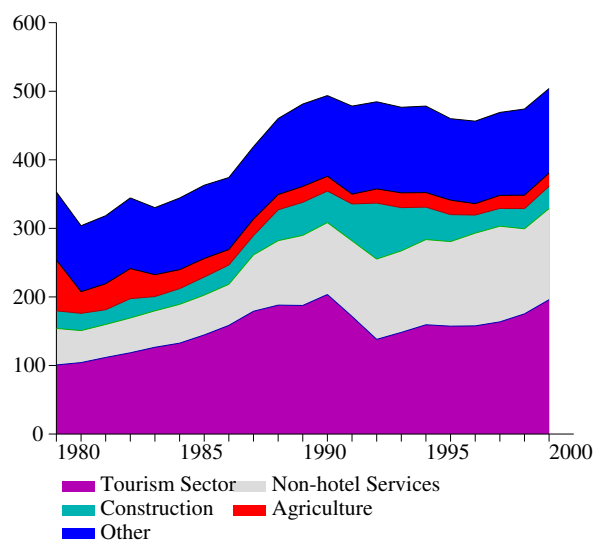


Figure 8: Real Labor Income by Sector

Over the past twenty years, a gradual diversification of the Kaua'i economy has indeed taken place. Figure 8 shows the real labor income generated by different sectors of the Kaua'i economy over time.¹ The figure clearly shows the transitory impact on the tourism and construction sectors from the late 1980s building boom and Hurricane Iniki in 1992. While

¹Changes in Federal government data reporting prevents extending this figure to include recent years at the present time.

real income in the tourism sector has grown significantly since 1992, it did not reach pre-Iniki levels until 2000. In fact, by 2000, the tourism sector's share (35%) of total real labor income was on par with its share in 1984.

In contrast, Figure 8 clearly demonstrates the increasing share of income earned in the services sector excluding hotels. This very broad category includes all forms of business, education, health and social services and even motion picture services income. This "non-hotel" service sector grew in absolute terms by 200% from the 1980s to the 1990s. The largest contribution to growth in the sector was from health services, almost 30% of the total growth, followed by business and engineering/management services, each contributing nearly 20% of the growth.

Interestingly, despite the closing of McBryde Sugar and Lihue Plantation, during the 1990s the agricultural sector has contributed a reasonably stable 4% of the County's total real labor income. You must go back to the early 1980s to find agriculture's share of total labor income as high as 10%. Finally, the last category in the Figure shows the real labor income generated by all other sectors in the Kaua'i economy. These other sectors include financial activities plus all sectors of government, including the military. This "all-other" category saw a very small decline in importance over the past two decades, with the federal civilian labor income category one of the few sectors increasing its share of total income.

So overall, the picture painted is one of very slow diversification. Tourism is still, despite Hurricane Iniki's wrath and the impact of 9/11, the dominant force in the Kaua'i economy. Yet the service sectors, especially technology, health and business services, are an increasingly dynamic part of the local economy, and one where new small businesses may well flourish in coming years. The growth of these industries will present new challenges for the Kaua'i economy, which we will return to at the end of Section III, below.

II. RECENT STATE DEVELOPMENTS

The Hawai'i economy continues to grow strongly. A hot housing market and associated construction spending support expansion in jobs and income, despite a less-than-complete recovery of a Japanese tourism market hit hard by the War in Iraq. The state economy is now in its best health since its downward slide in the early 1990s.

Interest rate sensitive sectors continue to provide the most support for the local economy. In 2003, new construction continued at a very robust pace, auto sales reached levels not seen in a decade, and sales of other consumer durable goods were also buoyant. Home sales boomed, and prices followed suit.

Lower mortgage and other interest payments have provided more discretionary income for local consumers, and more business for financial institutions. Even as home mortgage refinancing and move-ups decelerate, there are a backlog of construction projects that will continue to support growth for some time.

But the era of interest-rate driven growth is coming to an end. The Federal Reserve is expected to begin raising policy rates when it meets later this month, and long-term rates have already moved higher, by about 100 basis points over the past several months. Recent good news on the job front may mean that interest rate increases will be somewhat more aggressive than we expected earlier in the year.

The external economy, which was generally negative for Hawai'i in 2003, has since improved markedly. After a year that saw the buildup to the Iraq war and the onset of severe acute respiratory syndrome (SARS), both U.S. and Japanese economic conditions have improved. Higher fuel prices and the overseas deployment of Hawai'i-based U.S. forces act as a restraining force.

While external conditions are important, Hawai'i's economic expansion continues to be mostly home-grown. Growth is now increasingly

broad based, touching nearly every sector of the Hawai'i economy. 2004 will mark the eight straight year of economic expansion as measured by growth in state real (inflation-adjusted) personal income.

Notable developments over the past year include:

- The number of non-farm payroll jobs rose by a healthy 1.9% in 2003, and it has continued at roughly the same pace in the first four months of 2004. The job count reached 577,800 in April, on a seasonally-adjusted basis, another monthly record. Job recovery is broad based, with virtually all sectors seeing gains. As the recovery has strengthened, the labor force has begun to grow more rapidly, but still the seasonally-adjusted unemployment fell to 3.6% in April, considerably better performance than most other states.

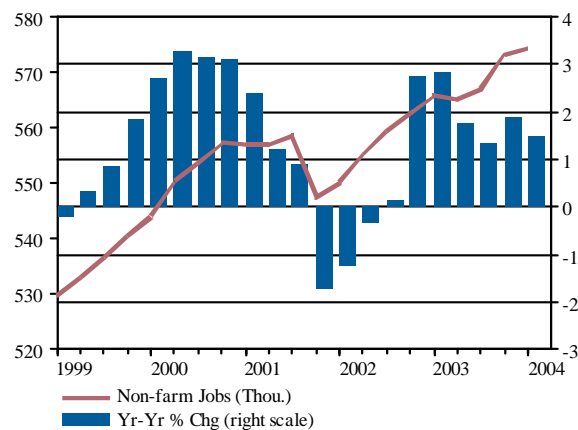


Figure 9: Hawai'i Non-Farm Payroll Jobs

- Not surprisingly, the strongest job performance has been in construction, which rose more than 7% in 2003. It has risen by 5.3% in the year through April. Financial Activities and Services—particularly Health Care—were also strong. Accommodations & Food Service jobs completed their recovery from the losses seen after 9/11, expanding 2% in 2003 and 2.2% year to date. State government payrolls were flat last year, while Federal jobs expanded by 3.2%

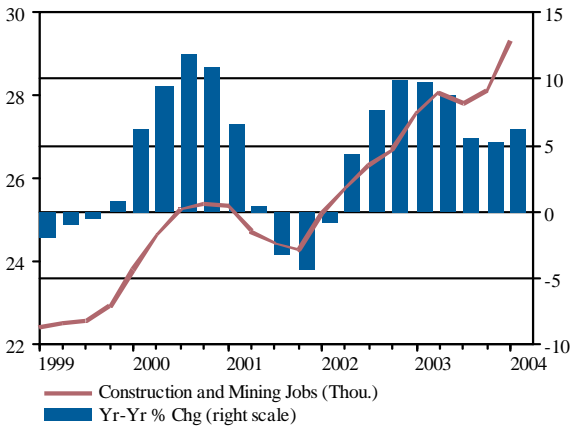


Figure 10: Hawai'i Construction Jobs

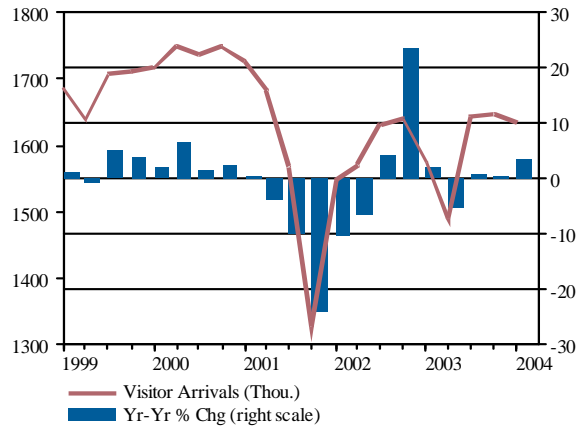


Figure 11: Hawai'i Visitor Arrivals

- Visitor arrivals for 2003 gave a misleading weak picture of tourism sector health. Arrivals were down slightly compared with 2002, with strong performance in the mainland U.S. market not quite offsetting weakness in Japanese arrivals. The number of U.S. visitors rose nearly 3% over 2002, while Japanese arrivals plummeted another 10.6% from already poor performance the previous year. But with significantly longer lengths of stay on both markets, the average daily census powered ahead by 2.9%. Total visitor days rose 2.8%, approaching the record levels set in the banner year of 2000. For the first quarter of this year, U.S. arrivals were up 6.5%, but Japanese arrivals, which had a very weak January and February, fell 1.6%. Japanese arrivals numbers were much better in April, giving hope that recovery will continue as the year progresses.
- Among the counties, Maui performed the best last year, posting nearly a 4% rise in visitors, due in part to its small dependence on the weak Japanese market but also very good performance in the U.S. market. O'ahu saw the largest arrivals drop (-4.9%) followed by Kaua'i (-3.3%), and the Big Island (-2.8%). Again, these arrivals numbers are somewhat misleading: revenue per available room was up substantially on all islands, ranging from 2.6% growth on Hawai'i to 9.2% on Kaua'i.

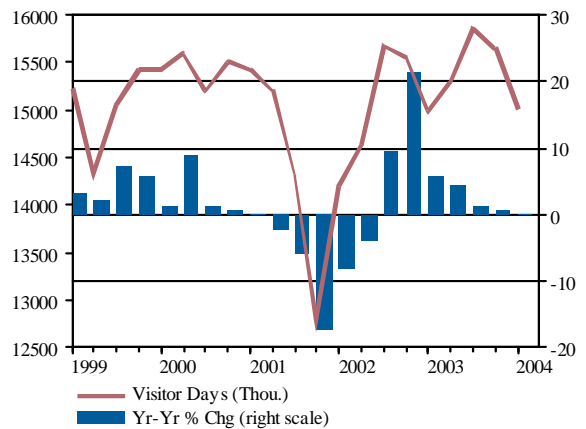


Figure 12: Hawai'i Visitor Days

- The state's general economic health has been reflected in income statistics. Real payroll income increased strongly last year in most sectors, rising 7.6% in construction, and 6% in wholesale trade, 10% in real estate, and 3–6% in many service sectors. Information technology continued to decline by 5% last year. Federal government civilian (5.5%) and military (6.3%) saw large real income gains. Overall real wage and salary income rose 4% for the year as a whole, and total real personal income rose 2.6%, down from the unusually strong 4.5% growth seen in 2002.
- The housing market remains very strong, with buoyant sales and rising prices. Sales of existing O'ahu single family homes hit 454 last July, and they have remained in the 300-400

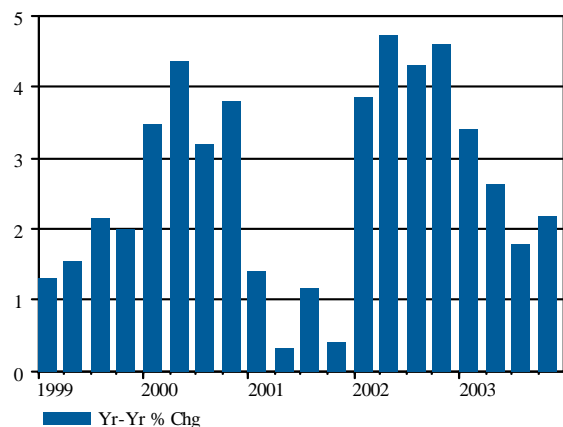


Figure 13: Hawai'i Real Personal Income Growth

unit range since then. Median O'ahu home prices hit \$445,000 in May, an all-time high, and the average number of days on the market is running at just 19 days. Prices of single-family homes are about 22% higher than a year ago; prices of condos are up nearly 18%. The Big Island and Kaua'i have seen much larger home price increase—for the first quarter of the year, median condo prices surged 50% on Kaua'i, and they nearly doubled on the Big Island compared with a year earlier.²

- The value of private building permits has receded from the extraordinary high volume seen in late 2002 and the first half of last year. Early last year they were running double the level of the same time in 2002, averaging \$240 million dollars per month. In the second half of the year, permits were running about \$160 million per month. Residential permits were 24% higher than in 2002, and commercial permits jumped 117% but fell off sharply late in the year. Government contracts awarded were lower by 25% for the first three quarters of the year, but this does not include the impact of the huge federal contracts for military housing. The continuing relatively high level of residential permitting suggests that the current construction boom has a life still in it, but military construction will begin to play a larger role. (UHERO prepares a separate Construc-

tion Outlook. Please contact us for more information.)

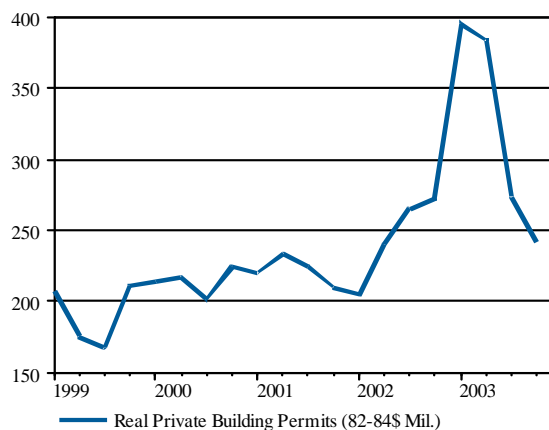


Figure 14: Hawai'i Real Private Building Permits

- The government fiscal condition has been on a general recovery path since its low point early in 2002. General funds revenues were 3.1% higher for the 2003 calendar year. General excise and use taxes were up a strong 8.4% in the calendar year, a reflection of strength in the broader economy. Personal income tax revenues were weaker reflecting significantly higher refunds for 2003. With particularly strong revenue growth in March, state tax collections for the first three quarters of the current fiscal year are running 6.8% ahead of last fiscal year.

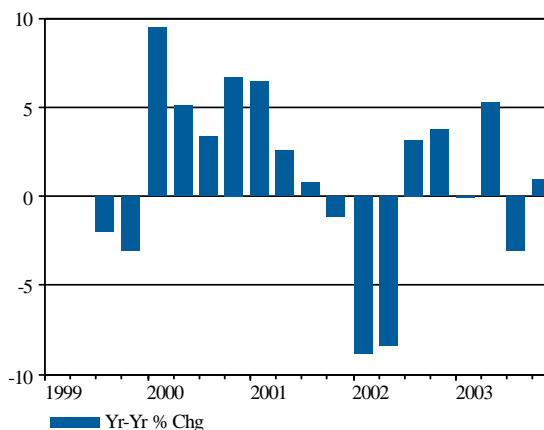


Figure 15: Hawai'i Real General Fund Tax Revenues

²Source: Prudential Locations Inc. Thanks to Glenn Iniba.

- As anticipated, Honolulu inflation has picked up over the past year, averaging 2.3% for the year. Most of this was due to higher energy prices, which drove utility costs up more than 8%. The rental (and for homeowners imputed rental) component of shelter costs remained very tame in Federal government estimates, rising just 2% over 2002 levels. This is hard to believe, and we still expect to see acceleration in this category over the next few years.

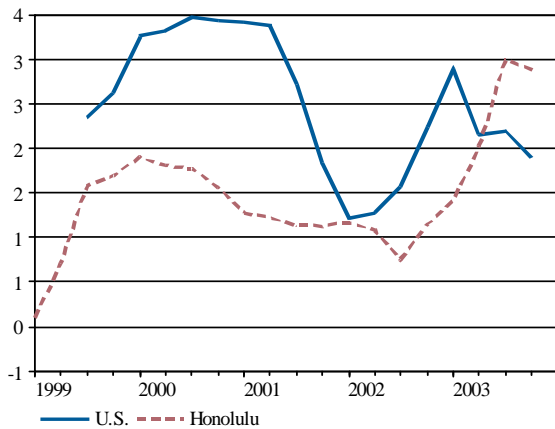


Figure 16: U.S. vs. Honolulu Inflation

III. KAUAI COUNTY FORECAST

Overview

Over the past three years, Kaua'i's economy has been among the healthiest in the state. Mainland tourism has been strong and the construction industry has been buoyant. The prospects are good for continued robust growth.

Developments in the U.S., Japanese and global economies contribute importantly to economic conditions on Kaua'i. Conditions in these economies have improved significantly over the past year, with broadening of the U.S. expansion and the emergence of genuine recovery in Japan. (See the overview of external conditions in section IV.) While high oil prices and rising interest rates may begin to slow global growth, the external environment should continue to be favorable for Kaua'i.

The strong demand for Kaua'i homes that we have seen over the past several years has fueled rapid growth in the construction industry. Last year, construction jobs expanded by nearly 7%, on the back of a 14% surge in 2002. With rising rates, we expect the industry to cool gradually over the next several years, but to continue to provide an import impetus to County growth.

Sector Highlights

Through the first four months of 2004, Kaua'i visitor arrivals on mainland flights were running 2.7% above their level in 2003. Japanese arrivals surged nearly 150% in April, finally beginning to make good on their recovery promise. Nevertheless, the recovery of Japanese travel to the island has been more attenuated than expected, and we expect only a 6% rise over last year for 2004 as a whole. Further growth in the 14% range is expected in 2005 and 2006. This will still leave Japanese visitor numbers far below their 2001 level of 122,000.

The number of mainland visitors is expected to rise 3% in 2004, a substantial improvement over

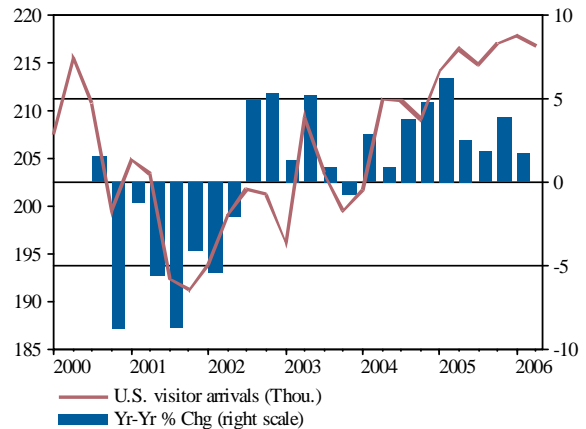


Figure 17: U.S. Visitor Arrivals to Kaua'i Forecast

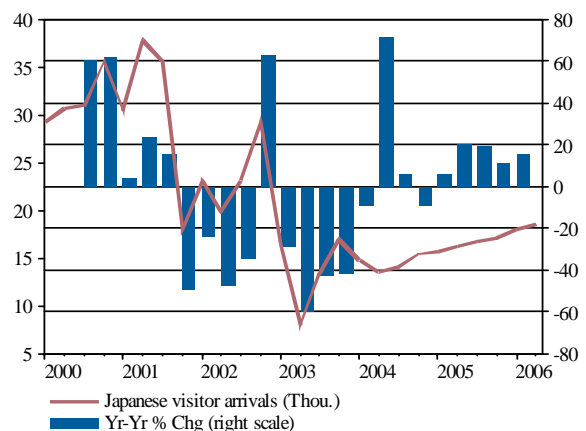


Figure 18: Japanese Visitor Arrivals to Kaua'i Forecast

last year's modest growth of 1.6%, and the domestic length of stay will remain high at about 7.2 days.

With limited Japanese recovery and continued strength on the domestic side, total visitor arrivals this year should expand by just over 4%. This would be the first annual increase in arrivals since 1999. Kaua'i's visitor count is expected to reach 1,013,000, just a bit off the 1999 high of nearly 1.1 million.

Average length of stay has been higher in the past few years than in the past, and it was particularly high (4.6 days) last year for international visitors. We expect international length of stay to recede somewhat over the next few years, so that growth in average daily census will fall short of the very high rate posted last year.

With a healthier tourism industry now in place, hiring has picked up. By the end of last year, there was a recovery of the roughly 300 accommodation and food service jobs that had been lost after 9/11. We expect another 400 jobs to be added by this sector over the next three years. Transportation, trade and allied areas will also add workers at a moderate pace.

Kaua'i's construction sector is no exception to the statewide boom in housing caused by very favorable lending rates, local income growth, and offshore demand. Residential permits have backed off quite a bit from the \$210 million worth seen in 2001, but still stood at \$153 million last year. We have already noted the rapid increase in construction jobs over the past three years. The relatively high rate of permitting still taking place suggests that high levels of construction employment can be sustained in the near term.

The service sector will continue to be a focus of job and income growth. Overall, service jobs are expected to expand by 2.7% this year before slowing to 2.2% in 2005. Health care and social assistance, one of the larger service sectors, will expand by just over 2% this year, slowing to the 1.5% range thereafter. The other services category—which includes professional services, business administration, education and several other smaller categories—will grow at an average rate of 2.7% over the next three years. Real income in the service sector will follow a similar pattern.

Changes in the cruise ship industry now promise a larger role for cruise visitors in the island economy. For the near term, these effects will not be large enough to affect the aggregate numbers. (See the box, *Hawai'i Cruise Industry On the Rise* in section I.)

As discussed above, the U.S. mainland market continues to dominate Kaua'i tourism, representing about 80% of the total in recent years. Japan and Canada together roughly comprise another 10%. This leaves only 10% of Kaua'i visitors who hail from other regions. There is the potential for this share to grow gradually in coming years as develop-

ing Asia in particular begins to apply rising income levels toward overseas tourism.

Aggregate Measures of Activity

With moderate tourism expansion and continued healthy activity in construction and service areas, we expect solid growth for the aggregate Kaua'i economy through 2006. Growth will drop down a notch from the particularly rapid expansion seen last year with some slowing of the housing sector. Overall job growth will be just under 2% this year, compared with 3.8% in 2003, on par with the job forecast for Hawai'i as a whole. Job growth of 1.5% is seen in 2005 and 1.2% in 2006.

Real (inflation adjusted) personal income represents the best measure of overall economic performance. Here we expect only a little slowing from the very robust performance of recent years. Real income for Kaua'i will grow 2.8%–3.2% over the next three years.

Inflation, which has begun to pick up in Hawai'i over the past year, will continue to accelerate to 3.2% this year as high energy prices and rising shelter costs filter through to overall prices. A persistent increase in inflation is not expected, and rates of price increase will decline thereafter.³ Combining real income and inflation forecasts, we see nominal (current dollar) income expanding by a little more than 6% in 2004–2005, dropping to 5.5% in 2006.

Kaua'i's Future Path

While Kaua'i's short-term prospects will be influenced in part by the global business cycle, many of its long run challenges are uniquely home grown. As we discussed in Section I, an issue of continuing concern is the desire to diversify the economy. As noted above, diversification on a limited scale has been occurring in recent years, as non-hotel service industries in particular gradually play a larger role in the Kaua'i economy.

³The U.S. Bureau of Labor Statistics surveys Hawai'i prices only for Honolulu, but similar price experience can be expected on the neighbor islands.

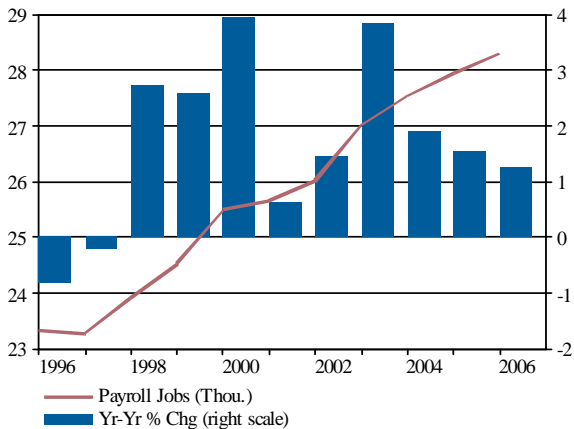


Figure 19: Kaua'i Non-Farm Job Forecast

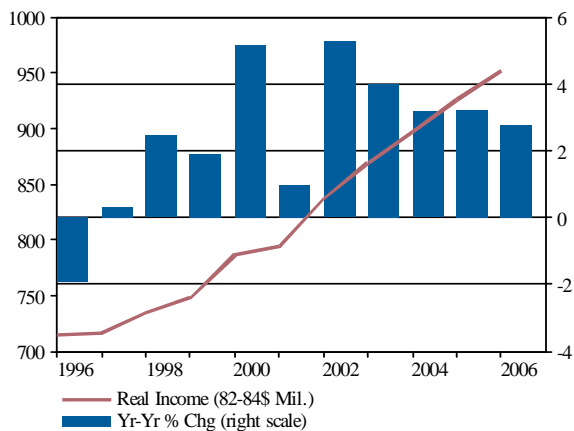


Figure 20: Kaua'i Real Personal Income Forecast

The evolution of Kaua'i's economy away from its traditional agricultural and tourism bases is broadly supported by elected officials and the general public. And progress in creating desirable high tech jobs is evident in the expansion of activities at PRMF and anecdotal evidence of in-migration by skilled individuals able to work at a distance from their job or market. The impact of these changes on aggregate job statistics is limited so far.

The in-migration of well-educated and highly-paid professionals bring both promise and pain. Kama'āina residents are concerned about maintaining the uniquely casual and congenial local environment and chafe at the construction of gated communities or ostentatious homes. There is a concern that inflows of affluent new residents will further drive up home prices, limiting access to housing for lo-

cal families of more modest means. At the same time, growth of a healthy diversified technically-sophisticated economy cannot occur without attracting and maintaining a skilled professional workforce.

The need to adequately equip the next generation of Kaua'i residents for this changing economy is a theme that has come up repeatedly in our discussions with local constituencies. There appears to be a consensus that improvement is needed at all levels of the education system. At the baccalaureate level, a four-year technical degree offered on Kaua'i would be very well received by local businesses that need graduates in this area. Some graduates might leave the island, of course, but they would have the alternative of continuing to live on Kaua'i.

Recently, the County of Kaua'i, in cooperation with local schools, Kaua'i Community College and the Kaua'i high-tech industry, has launched *Team Tech Kaua'i* to promote technical education both to give students the background they need to succeed in technology jobs and to create the quality workforce needed to grow the Kaua'i technology economy. The program, which also has the involvement of state the State Department of Education, the Kaua'i Economic Development Board, the county Office of Economic Development, and the U.S. Navy's Pacific Missile Range Facility, will have Kaua'i high tech firms "adopt" area schools and help provide support throughout the Kindergarten through higher education levels.

Natural limits to growth are also apparent. Recent moves to protect natural habitat pose potential challenges for all development in coming years. In March of last year, approximately 53,000 acres on Kaua'i and Ni'ihau were designated Critical Habitat for 83 endangered species by the U.S. Fish and Wildlife Service. While the acreage protected is only about half that originally proposed and most of the land is in remote areas, the potential impact on access for recreation use is a particular concern to some critics.

Despite the legitimate interest and potential promise of efforts to diversify Kaua'i's economy, for

the foreseeable future Kaua‘i’s economic heart will continue to be in its healthy tourism industry. That industry has performed well in difficult climate after September 11, 2001, benefitting from the growing desire by Americans for a safe, comfortable vacation on American soil. Media attention also demonstrates that the island has great appeal to more affluent visitors as well. Throughout the visitors industry there is interest in growing Kaua‘i tourism *intensively* rather than *extensively*, that is in promoting growth in daily spending and in lengths of stay rather than simply adding to the flow of visitors through the island.

A challenge will be to provide the infrastructure necessary for the industry’s move to a higher revenue model. This will include the need for upgrading and expansion of infrastructure, including roads, sewage, water, parks, and probably also ports. These needs may strain the County budget over the longer term. Tourism officials are also concerned that progress be made in reducing the incidence of drug-related crime.

The inflow of mainlanders to Kaua‘i presents a cultural clash for many kama‘āina residents. Demand by affluent residents may exert upward pressure on home prices on the island. At the same time, many new residents have skills and experience that can be tapped in meeting the challenges facing the local community. In this sense, welcoming and integrating new residents into the local economy may be important to foster Kaua‘i’s broader economic development goals.

IV. EXTERNAL CONDITIONS

The Hawai'i forecast relies in part on forecasts of external conditions in the U.S. and the Japanese economies. UHERO expects continued moderate expansion of the U.S. economy, and Japan's near term prospects are now quite good. Notwithstanding recent concerns related to high energy prices, global economic conditions are expected to be broadly supportive of continued robust growth for the Hawai'i economy. (UHERO also prepares an annual Global Outlook report; please contact us for more information.)

Forecast for the U.S. Economy

The U.S. economy expanded 4.1% in the final quarter of 2003 after an explosive 8.2% rise in the third quarter. Preliminary estimates of first quarter growth show 4.4% expansion. Retail sales made a particularly strong showing in the February to April period, up 8.3% from the previous year. Consumer confidence, though off from the bullish numbers at the time of the Iraq war, are still relatively optimistic. We expect 2004 growth to be in the 4% range, slowing a bit thereafter.

Labor market weakness has burdened the economy and the Bush administration since the recovery began in 2001. Though recovery has been underway for three years, job growth has been atypically weak, whether due as some critics claim to international *outsourcing* or more likely to better-than-expected productivity growth. Recent months—and some data revisions—have brought better news, but the unemployment rate remains at 5.6%. We expect labor market improvement to continue at a modest pace, so that the unemployment rate returns to the 4.5-5.0% range over the next two years.

The Federal fiscal picture has worsened considerably over the past year. The direct fiscal effects of the wars in Iraq and Afghanistan and the extra anti-terrorism security measures have raised federal spending sharply, at the same time that the modest recovery has restrained tax revenue growth.

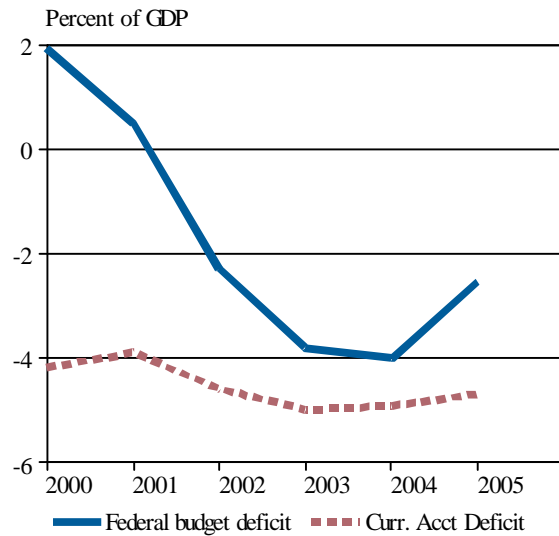


Figure 21: U.S. Fiscal and Current Account Deficits

To be sure, the most recent round of tax cuts and the added military and security spending has helped to keep the recovery going, and they will continue to play a supportive role over the next several years.

At the same time, the implications of mounting federal debt are worrisome. Current administration budget plans, which ignore sunset provisions in the major tax cuts and most of the ongoing costs in Iraq, are clearly unrealistic and unsustainable. Together with Americans' strong appetite for imports, government borrowing has fueled the reemergence of "twin deficits" on the budget and current account (trade balance), threatening higher interest rates and broader movements in the dollar. These concerns will probably not have marked adverse effects on the U.S. over the next few years, but represents a risk to the medium term outlook.

Monetary policy has played a leading role in supporting the economy through the 2001 recession and the past few years of sub-par growth. By cutting short-term interest rates, the Fed helped lower household and business borrowing costs. The picture has now begun to change, and the Open Market Committee is widely expected to begin raising the Federal Funds rate when it meets later this month. Long-term rates have already moved higher, anticipating the shift in policy but also heightened infla-

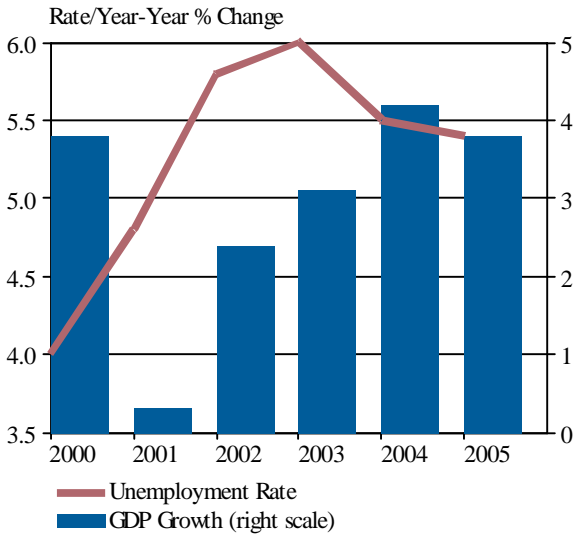


Figure 22: U.S. Real GDP Growth and Unemployment

tionary concerns and looming fiscal deficits. Lending rates are still relatively low by historical standards.

Higher oil prices will lead to at least a transitory up tick in national inflation. Continuing productivity gains will help to moderate this by holding core inflation (excluding food and energy) rates near the low levels we have seen in recent months. The overall CPI is averaging nearly 2.5% on a year-on-year basis these days, and will move to 3% before falling back in 2006 and beyond.

Forecast for the California economy

Because of the disproportionate importance for Hawai'i of the California economy, some consideration of prospects for that state is warranted. The tech downturn that began in 2000 hit the state hard, and its performance has been below the national average since. After two years of job losses and stagnant income, California is expected to accelerate this year, and to grow at a rate that once again exceeds the national performance over the long run.

At the end of the 1990s, California enjoyed robust growth, powered by its advantages in high technology and business services. Employment and income grew at rates that exceeded the national per-

formance. Real income in 2000 grew at 6.5% and unemployment fell to a low of 4.7% in December 2000. While these same strengths position California for strong growth in the future, the tech sector bust had a severe impact. Real income growth averaged -0.3% during 2001-2003, while the unemployment rate has risen to 6.7%, compared with a national average near 6%.

The California economy now appears to have turned the corner. After net job losses beginning in early 2001, the state economy posted year-on-year job gains for the first time in January and February of this year, and the unemployment rate has edged down to 6.2%. Real income growth is expected to rise to 3-4% for 2004, still likely below the national average.

Forecast for the Japanese Economy

Japan's recovery is on a firm path. The world's second largest economy has now posted eight consecutive quarters of positive growth, rising at a 5.6% annual rate in the first quarter. The economy has expanded by 4.7% over the past year. Most encouraging is the pickup in private demand, which has been very weak until now. Non-residential investment has been particularly strong, contributing more than half of last year's overall growth. The *Tankan* index of business confidence has improved steadily, particularly for large firms. The optimism of small and medium size manufacturers and non-manufacturing firms has shown slower improvement.

To be sure, Japan still faces challenges from a number of familiar structural problems: overcapacity in some key industries, continuing unresolved bad debt problems for the banking and commercial sectors, and a fiscal shortfall that has the government still borrowing nearly half of what it needs to fund spending. For the first time in a long time, it looks like the private sector may get the economy rolling in spite of these troubles, but, they still pose growth risks further out.

We expect Japan to see continued moderate growth at or above 3% in 2004. Slowing to about

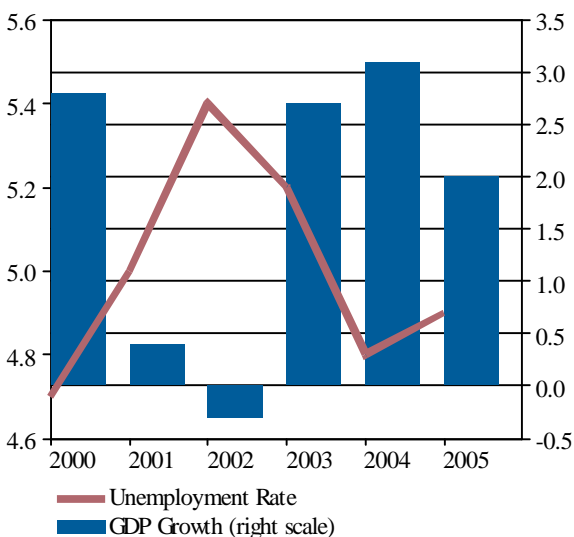


Figure 23: Japan real GDP growth and unemployment rate

2% is expected in 2005, in part because of the adverse effects on trade of a strong yen. Japan's labor market remains weak, but already some progress has been seen, with the unemployment rate falling from 5.5% in January 2003 to 5% in February 2004.

Japanese monetary policy in recent months has been focused on preventing further appreciation of the yen, which could stagger Japanese exports. Reportedly the Bank of Japan spent about 15 trillion yen (nearly \$150 billion) in the first quarter of the year to hold the yen down, but still the currency flirts with 100 yen/dollar "parity."

The Bank of Japan's war on the yen is in part based on continuing concerns about price deflation. A stronger yen would put more downward pressure on prices, which have been falling on average for five years now. Price deflation has been damaging to the Japanese economy because it undermines corporate profits, slashes property values and stock portfolios, increases real debt burdens and delays spending. Measured by the gross domestic product deflator, prices fell 2.6% in 2003. Consumer price deflation slowed to 0.3% last year, a promising sign. We expect that the more aggressive monetary stance evident in the recent foreign exchange interventions will begin to show results, allowing Japan to move to zero inflation this year or next.

On the structural front, there has been progress reducing Japan's huge stock of non-performing loans, partly as a result of government policy but more importantly because of rising stock prices that have improved credit worthiness. The government budget deficit continues to be among the highest of developed countries. The government budget deficit has been running at a rate of 7–8% of GDP now for six years, and it has accumulated debt of more than 150% of GDP (more than double the upper limit set by the European Union). This raises the risk that political pressure for tax increases and spending restraint could derail expansion as they did in 1997.

Forecast for the Rest of the World

The U.S. is leading the world economy, but growth prospects are improving almost world wide.

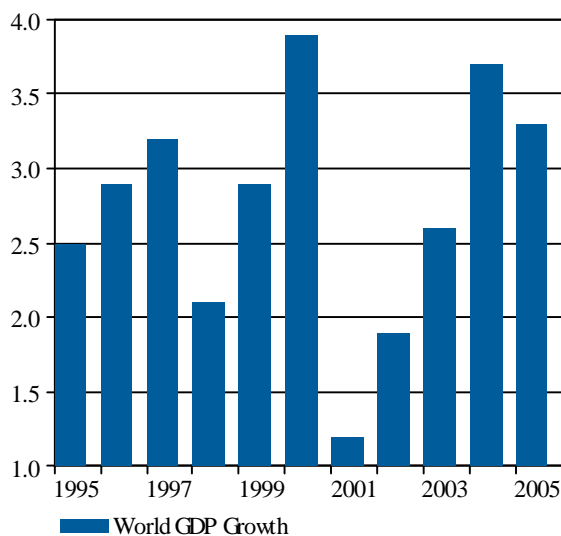


Figure 24: Global Real Output Growth

There was unexpectedly poor performance in Western Europe in 2003, where both Germany and France were essentially dead in the water. Growth prospects have improved in recent months, but still only about 1.5% growth is expected for these two key economies in 2004, in part because the euro's rise against the dollar is undercutting European competitiveness. Across the channel, things have been sunnier. The United Kingdom saw 2.4% growth last year and should expand at a better than 3% rate this year. Growth for the EU as a whole will

manage just 1.9% this year, before strengthening to 2.4% in 2005.

Last year East Asia was reeling both from the tech sector downturn and the emergence of a new threat: Sudden Acute Respiratory Syndrome (SARS). With tech on an upswing and SARS cases blessedly few this year, optimism in the region is growing. And a weaker dollar is helping promote exports of the region's many countries with dollar-linked currencies. We expect the South and East Asian region to grow 5.5% in 2004, up from 4.5% last year. The region should maintain growth in the 5% range into at least 2005. India and China will grow even faster.

Overall, gross world product, the broadest measure of global economic activity, will rise by 3.6% this year, considerably faster than the 2.6% seen in 2003. As the world economy approaches sustainable output, growth will slow modestly to 3.4% in 2005.

**Table 1: MAJOR ECONOMIC INDICATOR SUMMARY
2004 KAUAI COUNTY ECONOMIC FORECAST**

	2001	2002	2003	2004	2005	2006
Total Non-Farm Jobs	25.7	26.0	27.0	27.5	28.0	28.3
% Change	0.6	1.5	3.8	1.9	1.5	1.2
Total Population (000's)	59.1	60.0	60.7	61.2	61.6	62.1
% Change	0.9	1.4	1.2	0.9	0.7	0.7
Total Personal Income (Mil\$)	1,416.9	1,506.9	1,603.7	1,705.7	1,809.0	1,908.1
% Change	2.2	6.4	6.4	6.4	6.1	5.5
Inflation Rate, Honolulu MSA (%)	1.2	1.0	2.3	3.2	2.9	2.7
Real Personal Income (Mil82-84\$)	794.2	836.0	869.4	897.1	925.8	951.4
% Change	1.0	5.3	4.0	3.2	3.2	2.8
Real Per Capital Income (000's\$)	13.4	14.0	14.3	14.7	15.0	15.3
% Change	0.1	3.8	2.8	2.3	2.4	2.0
TOURISM SECTOR DETAIL						
Total Visitors (000's)	1,008.7	1,005.9	972.9	1,013.0	1,049.9	1,071.5
Japanese Visitors (000's)	121.7	95.2	54.4	57.7	65.6	75.1
U.S. Visitors (000's)	791.7	795.6	808.3	832.8	862.2	870.1
% Change - Total Visitors	-6.2	-0.3	-3.3	4.1	3.6	2.1
% Change - Japanese Visitors	-3.6	-21.8	-42.9	6.0	13.8	14.4
% Change - U.S. Visitors	-5.0	0.5	1.6	3.0	3.5	0.9
Domestic Avg. Length of Stay (Days)	6.7	6.8	7.1	7.2	7.2	7.1
Int'l Avg. Length of Stay (Days)	3.3	3.6	4.6	4.2	4.0	3.9
Avg. Daily Census (000's)	16.9	17.4	18.2	18.7	19.0	19.1
% Change	-5.5	-0.2	8.3	1.5	0.3	-0.2
Hotel/Motel Occupancy Rate (%)	70.5	70.4	76.2	77.4	77.6	77.4
Total Room Stock (000's)	7.2	7.0	7.3	7.3	7.4	7.5

Note: Population for 2002-2003 and income for 2003 are UHERO estimates.

Table 2: JOBS BY SECTOR (Thousands)
2004 KAUAI COUNTY ECONOMIC FORECAST

	2001	2002	2003	2004	2005	2006
Total Non-Farm Jobs	25.7	26.0	27.0	27.5	28.0	28.3
% Change	0.6	1.5	3.8	1.9	1.5	1.2
Agriculture	0.7	0.7	0.8	0.6	0.6	0.6
% Change	-31.8	10.7	9.1	-30.0	0.0	0.0
Construction	1.1	1.3	1.3	1.4	1.5	1.5
% Change	-1.6	17.9	5.6	7.0	1.3	2.0
Total Trade	4.2	4.1	4.3	4.4	4.4	4.5
% Change	1.1	-1.7	3.2	2.8	1.5	1.2
Finance, Insurance and Real Estate	1.2	1.2	1.2	1.2	1.2	1.2
% Change	6.9	-3.0	2.4	0.3	0.7	0.0
Services	13.2	13.3	13.9	14.3	14.6	14.9
% Change	na	0.8	4.5	2.7	2.2	1.7
Health Care and Soc. Assistance	2.0	2.1	2.1	2.1	2.1	2.2
Accommodation and Food	6.8	6.7	7.0	7.2	7.3	7.4
Others	4.4	4.6	4.9	5.0	5.2	5.3
Total Government	4.1	4.2	4.2	4.2	4.2	4.2
% Change	-0.2	2.1	0.5	-0.5	0.2	0.5
Federal Government	0.4	0.4	0.5	0.5	0.5	0.5
State and Local Government	3.7	3.8	3.7	3.7	3.7	3.7

**Table 3: PERSONAL INCOME DETAIL
2004 KAUAI COUNTY ECONOMIC FORECAST**

	2001	2002	2003	2004	2005	2006
Total Personal Income (Mil.\$)	1,416.9	1,506.9	1,603.7	1,705.7	1,809.0	1,908.1
% Change	2.2	6.4	6.4	6.4	6.1	5.5
Labor & Proprietors' Income (Mil.\$)	1,007.9	1,077.5	1,168.3	1,251.1	1,330.9	1,399.5
% Change	na	6.9	8.4	7.1	6.4	5.2
Construction	63.8	80.8	89.6	97.6	104.7	111.1
Services	463.2	478.4	517.1	549.2	583.8	617.5
Government	na	218.8	211.0	218.6	231.9	241.5
Less Social Security Taxes (-)	106.8	115.5	123.6	134.5	144.8	153.1
Transfer Payments	229.8	253.3	263.5	271.3	286.9	300.1
Dividends, Interest and Rent	278.1	283.6	295.6	317.8	336.0	361.6
Inflation Rate, Honolulu MSA (%)	1.2	1.0	2.3	3.2	2.9	2.7
Real Personal Income (Mil.\$)	794.2	836.0	869.4	897.1	925.8	951.4
%Change	1.0	5.3	4.0	3.2	3.2	2.8
Total Population (000's)	59.1	60.0	60.7	61.2	61.6	62.1
% Change	0.9	1.4	1.2	0.9	0.7	0.7
Real Per Capita Income (000's \$)	13.4	14.0	14.3	14.7	15.0	15.3
% Change	0.1	3.8	2.8	2.3	2.4	2.0

Note: Population for 2002-2003 and income for 2003 are UHERO estimates.

**Table 4: SUMMARY OF EXTERNAL DRIVERS
2004 KAUAI COUNTY ECONOMIC FORECAST**

	2001	2002	2003	2004	2005	2006
U.S. FACTORS						
Total Employment (000's)	136,933.0	136,485.0	138,098.7	139,910.0	142,156.8	144,193.5
% Change	0.0	-0.3	1.2	1.3	1.6	1.4
Unemployment Rate (%)	4.8	5.8	6.0	5.5	5.4	5.1
Inflation Rate (%)	2.8	1.6	2.3	2.0	2.2	2.4
Real GDP (Bil.96\$)	9,214.6	9,439.9	9,724.4	10,132.8	10,517.8	10,879.6
% Change	0.3	2.5	3.0	4.2	3.8	3.4
Population (000's)	288,025.0	291,038.0	294,043.0	297,043.0	300,038.0	303,028.0
% Change	1.1	1.1	1.0	1.0	1.0	1.0
JAPAN FACTORS						
Total Employment (000's)	64,120.0	63,300.0	63,265.0	63,555.3	63,944.0	64,270.7
% Change	-0.5	-1.3	-0.1	0.5	0.6	0.5
Unemployment Rate (%)	5.0	5.4	5.2	5.2	4.8	4.9
Inflation Rate (%)	-0.7	-0.9	-0.2	-0.3	0.0	0.3
Real GDP (Bil.90Y)	534,870.1	533,022.4	544,710.2	561,596.2	572,828.2	587,263.4
% Change	0.4	-0.4	2.2	3.1	2.0	2.5
Population (000's)	127,271.0	127,478.0	127,654.0	127,800.0	127,914.0	127,998.0
% Change	0.2	0.2	0.1	0.1	0.1	0.1
Exchange Rate (Yen/\$)	121.6	125.3	111.1	107.7	105.3	103.9